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CAPITAL MARKETS LEGISLATION AND EMISSION ALLOWANCES: A FRUITFUL MARRIAGE?

1. Introduction. Trading in EUAs.

Emission allowances trading schemes are far from being a novelty[1]. Back in 2003, a European system for trading carbon

[1] There is considerable literature on the EU emissions trading scheme that considers both economic and regulatory issues. For a focus on the latter see, also for further references, J. Van Zeben, *The Allocation of Regulatory Competence in the EU Emissions Trading Scheme*, Cambridge: Cambridge University Press, 2014; J.B. Skjaerseth and J. Wettestad, *EU Emissions Trading: Initiation, Decision-Making and Implementation*, Surrey: Ashgate, 2008; J. Wettestad and T. Jevnaker, *Rescuing EU Emissions Trading: The Climate Policy Flaghsip*, London: Palgrave Macmillan, 2016.

emissions was first set up, within the broader framework of the Kyoto Protocol and of the international agreements for the reduction of CO_2 emissions. At the time, the EU Commission endorsed the position that Emissions Trading Schemes (ETS)—together with the other tools introduced by the Protocol itself—would provide a strong contribution to the global reduction of CO_2 emission[2]. An EU system for trading in European Union Allowances (EUAs) was then established and later revised in order to overcome some of its original shortcomings[3].

2. ETS and governance of emissions.

Directive 2003/87/EU of 13 October 13 introduced a harmonised and centralised regime for emissions trading, which has been, since its inception, in continuous operation, albeit its first 15 years proved to be, at times, troublesome. The EU ETS system – effectively operational since 2005 – set up a structured and standardised system of electronic registers, which allows for the transfer, the safekeeping and the writing-off of rights on emission allowances in Europe. In the infancy of the EU ETS, each Member State had its own register, but, starting from 2012, national registers were substituted by the EU one.

The ETS scheme is the largest scheme in operation for reducing GHG emissions, accounting for more than three-quarters of international carbon trading worldwide. It has inspired the

[2] In September 2004 the European Commission — being called upon by the European Council to prepare a cost/benefit analysis on emissions reduction strategies, including mid- and longer-range targets — launched a consultation to gather ideas and research results from stakeholders on a global climate change regime for the future. Consequently, a conference was held on 22 November and the comments and information included into the Commission's report for the Council, *i.e.* the Communication "*Winning the Battle Against Global Climate Change*", adopted on 9 February 2005.

[3] The latest revision of the EU ETS Directive was adopted in 2018. In 2021, to align the EU ETS Directive with the increased emission reduction targets set in the European Climate Law, the Commission proposed new amendments to the EU ETS Directive.

development of similar programmes across the world, at national, sub-national, and regional levels.
The EU ETS has been established and extended over four successive phases:
- Phase I started in 2005 and ended in 2007 and is often referred to as 'the pilot phase', or the 'pre-Kyoto' period. This a pilot phase, introduced to test the system and to establish its infrastructure. Almost all EUAs were allocated for free. Reliable data on emissions were unavailable at the time, and emission caps were set on the basis of estimates;

- Phase II started in 2008 and ended in 2012, coinciding with the first commitment period under the Kyoto Protocol. EU Member States (and the three EFTA states Iceland, Norway and Liechtenstein, which joined the EU ETS) had to meet concrete emission reduction targets. Free allocation covered roughly 10% of EUAs auctioned on the market. There was a surplus of credits, that, together with the 2008 crisis, led to very low carbon prices. In 2012 aviation emissions from flights within the EEA were brought in scope of the EU ETS;

- Phase III started in 2013 and ended in 2020. The EU ETS Directive was revised and improved in several aspects. Even though a number of EUAs was still allocated for free, auctioning was set as the default mechanism. Some criteria were introduced in order to prevent transfer of production to other countries with less stringent constraints. The third phase started with a significant surplus of EUAs : as a consequence, auctioning of a considerable number of EUAs was delayed (so-called back-loading); and
- Phase IV started in 2021 and is expected to run until 2030[4]. This phase is characterized by a cap aligned to the EU's target of reducing greenhouse gas emissions by 40% compared to 1990 levels.

[4] For a comprehensive overview of the different phases, see S. De Clara, K. Mayr, "The EU ETS phase IV reform: implications for system functioning and for the carbon price signal", Oxford Institute for energy studies, September 2018.

Emission trading schemes are generally described as market-based instruments for the control of emissions, to be used in combination with publicly-based ones, such as, typically, emission caps set by public authorities. In the Green Paper on market-based instruments for environment and related policy purposes, the European Commission noted that: "*The economic rationale for using market-based instruments lies in their ability to correct market failures in a cost-effective way. Market failure refers to a situation in which markets are either entirely lacking (e.g. environmental assets having the nature of public goods) or do not sufficiently account for the "true" or social cost of economic activity. Public intervention is then justified to correct these failures*"[5].

In the literature, several reasons are generally set out to support the assumption that emission allowances trading schemes produce positive externalities.[6] First of all, ETSs seem to contribute to the definition of a price on carbon that is clearer and more predictable over time.[7] The costs generated by CO_2 emissions and their negative impacts (public health, weather conditions, extinction of parts of the animal or vegetable world, etc.) are made more transparent and are more easily incorporated into the price of goods and services.

It is generally agreed that emissions trading schemes themselves do not, directly, produce a reduction of greenhouse gas emissions. The EU Court of Justice in *Société Arcelor Atlantique et Lorraine et al.*[8]

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[5] Green Paper on market-based instruments for environment and related policy purposes of 28.03.2007, COM(2007)140 final, point 2.1.

[6] T.H. Tietenberg, *Emissions Trading. Principles and Practices. Resources for the future*, 2nd ed., Washington, DC: Routledge, 2006.

[7] For further information on the progress of the concrete impacts of the ETS, please see the Report from the Commission to the European Parliament and the Council - Report on the functioning of the European carbon market (COM/2019/557 final/2), available at the following link: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52019DC0557R(01).

[8] Judgement of the Court of Justice of 16.12.2008, C-127/07 *Société Arcelor Atlantique et Lorraine and Others versus Premier ministre, Ministre de l'Écologie et du Développement durable i Ministre de l'Économie, des Finances et de l'Industrie*, ECLI:EU:C:2008:728.

(Case C-127/07, decision of 16.12.200) rightly remarked that: "*While the ultimate objective of the allowance trading scheme is the protection of the environment by means of a reduction of greenhouse gas emissions, the scheme does not of itself reduce those emissions but encourages and promotes the pursuit of the lowest cost of achieving a given amount of emissions reductions* (…). *The benefit for the environment depends on the stringency of the total quantity of allowances allocated, which represents the overall limit on emissions allowed by the scheme* (paragraph 31).

ETSs must therefore be combined with cap limits on emissions: with a steadily declining cap on emissions, an ETS delivers a predictable path for their reductions, setting a long-term goal for businesses and investments. For this purpose, as of 2010, a declining cap to the quantity of emission allowances was set out (until 2020 and beyond), so as to enable market participants to promptly adjust their investment decisions and environmental policies.

Flexibility is generally described as another advantage of ETS: systems may be designed according to different rules that fit multiple environments and economic systems. ETSs might even provide additional sources of revenues for governments, when combined, for example, with a system of auction of permits. Different ETSs can also be linked to one another, so as to increase the size of the market, thus making it sturdier and more efficient.[9]

Over time, the EU legislator became gradually more aware of the need to improve the framework of secondary markets trading for EUAs, looking for increased transparency, liquidity and integrity[10]. Most of these arguments are at the basis of the decision to fully integrate EUAs into the MiFID framework.

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[9] The number of emissions trading systems around the world has been steadily growing. In addition to the EU ETS, national or sub-national systems are operating or under development in Canada, China, Japan, New Zealand, South Korea, Switzerland and the United States. The European Commission is also a founding member of the International Carbon Action Partnership (ICAP), which brings together countries and regions with mandatory cap-and-trade systems.

[10] See on these aspects, European Commission, *Legal nature of EU ETS allowances. Final report*, Luxembourg 2019, available at:

3. Emission Allowances Within the Scope of Capital Markets and Financial Legislation.

While the structure and the mechanisms that underpin the functioning of the EU ETS system are, by now, well known, and there is considerable literature on the topic, discussions on the protection of the environment and the development of secondary markets for emission allowances have stimulated a process of gradual inclusion of CO_2 allowances in the perimeter of financial markets regulation. This process developed alongside two different directions: the first saw the progressive inclusion, within the legislation on auctions and exchange of emission allowances, of rules clearly based and modelled upon capital markets and financial legislation. The second direction — which ultimately somehow prevailed over the first — shows the direct inclusion of emission allowances within the scope of capital markets legislation, especially MiFID (firstly, MiFID I, then MiFID II) and MAR.

Efforts to improve the effectiveness of the trading scheme the market imbalance are also supported by a faster reduction of the annual emissions cap, agreed as part of the revision of the EU ETS. The overall number of emission allowances will decrease at an annual rate of 2.2% from 2021 onwards, compared to 1.74% in the period 2013-2020. The reduction rate is in line with the 2030 target of at least 40% cuts in EU greenhouse gas emissions compared to the level of the eary '90s.

3.1. Emission Allowances in MiFID I.

The original EU ETS — notwithstanding its potential benefits — soon provoked the undesirable manifestation of excessive speculation and abusive conduct, stimulated by its somewhat fluid

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https://op.europa.eu/en/publication-detail/-/publication/9d985256-a6a9-11e9-9d01-01aa75ed71a1.

regulatory framework as well as by the absence of an effective repressive apparatus. Article 12, paragraph 1-*bis* of the EU ETS Directive—as amended by the 2009 Directive[11]—empowered the Commission with the task to "*examine whether the market for emissions allowances is sufficiently protected from insider dealing or market manipulation*" and, if appropriate, "*bring forward proposals to ensure such protection*".

In its subsequent Communication to the Parliament and the Council,[12] the Commission noted that "*although the European carbon market has grown significantly both in size and sophistication during its first six years of operation, it remains a relatively young market. It is therefore important to ensure that such market can continue to expand and safely be relied upon to give an undistorted carbon price signal. It follows that the market needs to have an appropriate market oversight framework. Such framework needs to secure fair and efficient trading conditions for all market participants through transparency requirements as well as by preventing and sanctioning market misconduct, in particular insider dealing and market manipulation*"[13].

[11] Reference is made to Directive 2009/29/EC amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community.

[12] Reference is made to COM (2010) 796 final, named "Towards an enhanced market oversight framework for the EU ETS", issued in Brussels on 21 December 2010, p. 2.

[13] The European Commission noted that, during 2009 and 2010, three incidents occurred in the European carbon market which illustrated the wider range of risks that needed to be dealt with. Although these incidents did not constitute market abuse in the sense of the Market Abuse Directive, they did give rise to calls for stricter regulation of the European carbon market, *i.e.*: (i) cases of value-added tax (VAT) fraud were detected in the carbon market in 2009–2010. While presenting a serious problem, this type of fraud is not specific to the carbon market and has in the past occurred on other markets as well. The Commission worked closely with Member States to fight this issue, and a new Directive on the application of the VAT reverse charge mechanism for emissions trading was adopted on 16 March 2010; (ii) so-called phishing attacks from fraudsters trying to get unauthorised access to accounts of market participants are also not specific to the carbon market, but nevertheless prompted the Commission to take rapid actions in cooperation with Member States; and (iii) the resale in the European carbon market by a Member State of emission units that had already been used for EU ETS compliance. This was an incident specific to the carbon market.

In effect, shortly before the above-mentioned Communication, the Commission had already issued measures aimed at preventing market abuse in the EUAs auction market, setting them out in Regulation n. 1031 of 12 November 2010 (so-called Auction Regulation).
In particular, in a regulatory framework based on the definition of financial instrument given by MiFID I—which did not contemplate emission allowances except when they represented the underlying of derivative contracts—the Auction Regulation actually extended the rules and safeguards established by the Market Abuse Directive of 2003 to ETS, regardless of the qualification of emission allowances as financial instruments. To this end, a first regulatory microcosm on market abuse was provided for within that same Auction Regulation, actually mirroring the Market Abuse Directive ("MAD"), including its definitions, the identification of prohibited conducts, supervisory powers and sanctions. Those rules also extended to EUAs the definition of inside information, as well as the basic division between insider trading and market manipulation, provided for by the MAD.[14]
Looking at the second trend—*i.e.* the direct inclusion of emission allowances in the scope of MiFID and market abuse legislation—a first, significant step in this direction was taken in 2004, *i.e.* six years before the Auction Regulation, in the context of MiFID I. Building extensively upon the definition of commodity derivatives originally introduced by the Investment Services Directive of 1993, MiFID I enlarged the catalogue of derivatives that fell into its scope. The catalogue included then derivatives on emission allowances. This enlargement of the scope of the Directive, and consequently of the regulation of investment services and

[14] The Auction Regulation provided for a definition of insider dealing and market manipulation. According to its Article 3(28), "insider dealing" is "the use of inside information as prohibited pursuant to Articles 2, 3 and 4 of Directive 2003/6/EC in relation to a financial instrument within the meaning of Article 1(3) of Directive 2003/6/EC referred to in Article 9 of that Directive unless otherwise stated in this Regulation", thereby referring to MAD conducts. Under Article 3(30) of the Auction regulation, also "market manipulation" was defined in a similar way, by referring to Article 1(2) of Directive 2003/6/EC.

activities, made by MiFID I, to encompass a part of the secondary market for EUAs, was not, however, an easy exercise. The need clearly arose to keep some of the main lines of business of commodity producers and traders away from the grip of financial markets regulations. MiFID I, thereby, introduced a number of quite complicated exemptions for commodity derivatives trading by firms not operating otherwise in the financial sector, setting a standard that is now also to be found in MiFID II.
In principle, in MiFID I, a derivative on emission allowances would therefore be treated no differently than any other derivative on commodities or other underlying "assets". The well-known issues concerning the exact perimeter, and the precise line of division, between financial and commodity derivatives (the latter to be considered of a commercial nature, thereby falling outside the scope of MiFID), would also apply to derivatives on emissions trading, similarly to other commodity derivatives.
Ultimately, therefore, the room that MiFID I left to the provisions of the Auction Regulation was quite significant: one might rightly say that, until MiFID II, the lead in terms of addressing markets' efficiency and preventing market abuse in relation to emission allowances was effectively left to the Auction Regulation, and to its provisions, modelled on those of the MAD of 2003. Most of the transactions on emission allowances would, in fact, have ultimately fallen outside the scope of MiFID I.

3.2. Emission Allowances in MiFID II.

The landscape set by MiFID I was, indeed, just a first step towards the inclusion of emissions trading into the scope of financial markets legislation. The second step has ultimately been taken by MiFID II, as the latter directly classifies rights on emission allowances falling in the EU ETS as financial instruments. With a simple addition to the list of financial instruments, attached to the Directive under Annex I, emission allowances *per se* have therefore become financial instruments (see n. 12 of the list of financial instruments—Annex I, Section C). In addition, the approach that considers emission allowances as relevant for MiFID purposes —

if they are employed as the underlying asset of a derivative that relates to the indexes required for a derivative to be considered as having a financial nature — basically remains unchanged in MiFID II *vis-à-vis* its predecessor MiFID I.[15]

It should be noted that the inclusion of emission rights in the scope of MiFID did not address the issue of qualifying them more precisely under general private law: this was, indeed, unnecessary since MiFID provisions aim at regulating transactions on the markets of financial instruments, leaving it to national law to qualify/define their legal nature. It is not surprising, therefore, that also the Court of Justice decided not to rule on this matter, which is actually not covered by EU Law[16].

[15] On these topics cfr. A. Sciarrone Alibrandi, E. Grossule, "Commodity Derivatives", in D. Busch, G. Ferrarini (eds.), *Regulation of the EU Financial Markets. MiFID II and MiFIR*, Oxford: OUP, 2017, Chapter 16, pp. 439 ff. Some preliminary remarks, before MiFID II came into force, can also be found in F. Annunziata, "Strumenti derivati, disciplina del mercato dei capitali ed economia reale: una frontiera mobile. Riflessioni a margine del progetto di revisione della MiFID", in *I contratti "derivati": dall'accordo alla lite*, U. Morera and R. Bencini (eds.), Bologna: Il Mulino, 2013, 13 ff.

[16] Case C-321/15, 8.03.2017, C-321/15 *ArcelorMittal Rodange et Schifflange SA versus State of the Grand Duchy of Luxembourg*, ECLI:EU:C:2017:179. The Court stated that forcing *surrender of EUAs would not mean the expropriation of an asset which already formed an integral part of the operator's property, but simply the withdrawal of the act allocating the allowances, on account of the failure to comply with the conditions laid down in Directive 2003/87* (point 38 of the judgement). In the literature, the prevailing opinion seems to uphold the qualification of EUAs as intangible property rights. For further references see B. Holligan, "Commodity or Propriety? Unauthorised Transfer of Intangible Entitlements in the EU Emissions Trading System", Modern Law Review 2020, Vol. 83, No. 5, p. 980, pp. 982–989 and 1007; R. Wilhelmi, "Commodification and Financialization in the Energy Sector: Emission Allowances and Electricity" in *Regulatory Property Rights: The Transforming Notion of Property in Transnational Business Regulation* (ed. C. Godt), Leiden: Brill/Nijhoff 2016, p. 203. For further referecences, see also L. Bennet, "Are Tradable Carbon Emissions Credits Investments? Characterization and Ramifications under International Investment Law", New York University Law Review 2010, Vol. 85, No. 5, pp. 1597–1598; M. Colangelo, *Creating Property Rights. Law and Regulation of Secondary Trading in the European Union*, Leiden: Martinus Nijhoff Publishers, 2012, pp. 177–181; K. Gorzelak, "The legal nature of emission allowances following the creation of a Union Registry and adoption of MiFID II – are they transferable securities now?" Capital Markets Law Journal 2014, Vol. 9, No. 4, pp. 373–387; K.F.K. Low, J. Lin, "Carbon Credits as EU Like It: Property, Immunity, TragiCO$_2$medy?", Journal of Environmental Law 2015, Vol. 27, No. 3, pp. 377–404; E. Yliheljo, "The Variable Nature of Ownership of Emission Units in the Intersection of Climate

The uncertainty as to the legal qualification of EUAs – which is typical of all assets falling under the scope of MiFID and, more recently, also of the upcoming legislation of crypto-assets in the EU (MiCA) - does not seem to be an obstacle to the development of secondary markets, focused on liquidity and transferability of EUAs[17].

During the preparatory phase of MiFID II, the decision to include EUAs fully within its scope was considered against the alternative to developing, under EU Law, a special regime for secondary trades in EUAs[18]. While both alternatives were expected to produce some benefits, ultimately, the decision to extend MiFID to spot transactions in EUAs prevailed: it followed the idea that the approach would indeed increase transparency and efficiency of the secondary market, improve its liquidity, and contribute to reduced transaction costs[19].

When MiFID II was discussed, it became therefore evident that the previous approach — a blurred mixture of the Auction Regulation and MiFID I — was not sufficient anymore. As the Commission observed in its FAQ of 2014: "*Trading in allowance derivatives already falls under the scope of MiFID and Market Abuse Directive. By now bringing emission allowances under the same framework, the regulation on emission allowances trading (EUA), the spot market will be aligned*

Law, Property Law, and the Regulation of Financial Markets", Climate Law, Vol. 11, No. 1, 2021, pp. 45–75.

[17] This is a general feature of MiFID: for instance, MiFID does not even define what is, from a private law perspective, a "share", a "bond", a "transferable instrumenti", etc. leaving it to national legislation. See European Commission, *Legal nature…*, cit.

[18] European Commission, *Commission Staff Working Paper. Impact assessment accompanying the document Proposal for a Directive of the European Parliament and of the Council on Markets in Financial Instruments and the Proposal for a Regulation of the European Parliament and of the Council on Markets in Financial Instruments*, SEC(2011) 1226 final, Brussels, 20.10.2011, available at: https://ec.europa.eu/transparency/documents-register/detail?ref=SEC(2011)1226&lang=en.

[19] N.J. Clausen, K.E. Sørensen, "Reforming the Regulation of Trading Venues in the EU under the Proposed MiFID II – Levelling the Playing Field and Overcoming Market Fragmentation?", European Company and Financial Law Review 2012, Vol. 9, No. 3, p. 278 and 296–297.

with what is applicable to the EUA derivative markets. Together, MiFID and the rules on market abuse provide a comprehensive framework for trading in financial instruments and the integrity of the market. The extension to EUAs will introduce greater security for traders of EUAs but without interfering with the purpose of the market, which remains emissions reduction".

One may wonder whether — in the Commission's words — reference to market abuse would be merely a consequence of the expected inclusion of emission allowances in the scope of MiFID II or whether it was, in fact, the driving force behind the new approach. We believe that the right way to look at this is, in a first moment, to turn the two factors the other way around: because of the need to prevent manipulative practices on the markets of emission allowances, these would effectively need to be fully covered by MiFID II. This is, naturally, because rules against market abuse apply to financial instruments as defined by MiFID II, and thus, two masters (like the Arlequin in Carlo Goldoni's seminal comedy of 1746) are served at once and at the same time.

It should be underlined that treating emission allowances as financial instruments also implies that the trading platforms on which the allowances are exchanged via spot transactions become subject to the comprehensive MiFID II provisions on trading venues.

The new MiFID II approach therefore has far-reaching consequences, as it impacts not only trading activities and other investment services, but also trading venues and the structure of secondary markets for emission allowances, subjecting also the latter to the typical forms of supervision and control that one finds in the area of EU capital markets legislation.

3.3. Emission Allowances Under MAR.

The trend towards the inclusion of emission allowances into the scope of EU capital markets legislation was also accelerated by Regulation (UE) n. 596 of 16 April 2014 (so-called MAR), which replaced the previous Market Abuse Directive. Recital 37 of MAR—after having recalled the previous existence of a specific market abuse regime exclusively dedicated to the auctions of emission allowances — clarifies that "*as a consequence of the classification of emission allowances as financial instruments, this regulation should constitute a single rule book of market abuse measures applicable to the entirety of the primary and secondary markets in emission allowances*". It follows that the MAR legal framework "*should also apply to behaviours or transactions, including bids, to the auctioning on an auction platform authorised as a regulated market of emission allowances or other auctioned products based thereon, including when auctioned products are not financial instruments, pursuant to Auction Regulation*".

As a consequence thereof, the concerns of a regulatory *vacuum* that induced the European Commission to insert provisions against market abuse within the Auction Regulation were no longer justified, as emission allowances were entirely brought into the warm embrace of EU capital markets legislation.

Considering MAR, there are basically two aspects that make the position of emission allowances peculiar in the context of the regulation. The first is due to the fact that emission allowances are also regulated in other areas of EU legislation, which ultimately also touch upon issues of transparency, market information and efficiency. As already discussed, specific rules aimed at preventing abuses in the emission allowances markets had already been introduced before MAR, in EU legislation governing emission allowances (in particular, the Auction Regulation). The entry into force of MiFID II and MAR produced, as a consequence, the repeal of those specific provisions, but emission allowances do remain subject to their own sectorial rules, which require to be somewhat coordinated with MAR. This is something quite peculiar to emission allowances, as other financial instruments included in MiFID II or MAR are not subject to the same approach[20].

The second aspect is that MAR must take into account that inside information, for emission allowances, needs to be treated in a

[20] On the functioning of MAR, particularly in relation to oversight and enforcement, in relation to EUAs, see the extremy valuable information available in ESMA, *Final Report: Emission allowances and associated derivatives*, 28 March 2022, ESMA70-445-38.

peculiar way when considering issues such as the disclosure of inside information, or, for instance, information-based market manipulation.

Concerning the first element (*i.e.* the interrelationship between MAR and other sectoral legislation), there are several examples to be found in the text of the regulation. One of the most interesting ones is the "reasonable investor test". According to recital (14), the "reasonable investor test" should, in general, take into account the *ex ante* available set of information, and its "anticipated impact", to be considered in light "*of the totality of the related issuer's activity, the reliability of the source of information and any other market variables likely to affect the financial instruments, the related spot commodity contracts, or the auctioned products based on the emission allowances in the given circumstances*". However, for emission allowances, the test must be necessarily carried out also in the light of "any other market variables", including — as recital (14) sets out — "auctioned products based on emission allowances". In a similar way, for emission allowances, the "precise" nature of inside information needs to be assessed by looking at its "*potential effect on the prices of the financial instruments, the related spot commodity contracts, or the auctioned products based on the emission allowances*" (MAR, recital 18). In addition, "*for derivatives which are wholesale energy products, information required to be disclosed in accordance with Regulation (EU) No 1227/2011 of the European Parliament and of the Council should, in particular, be considered as inside information*" (MAR, recital 18).[21]

It is interesting to note that, both in recitals (14) and (18), reference is made to "*auction products based on the emission allowances*": this sets up a connection between the regulation of the auction markets for emission allowances and that of secondary markets for their

[21] Consistently with MAR, Article 2 of REMIT Regulation - Regulation (EU) No 1227/2011 - establishes that "inside information" means information of a precise nature which has not been made public, which relates, directly or indirectly, to one or more wholesale energy products and which, if it were made public, would be likely to significantly affect the prices of those wholesale energy products.

exchange. A similar "bridge" is also set out by recital (26)[22], with an approach that derives from the one originally taken in the (now repealed) provision of the Auctions Regulation. This is equally a consequence of the re-shaping of market abuse provisions for emission allowances, from the previous to the current regime.
Recital (21) of MAR also sets out a specific, and quite elaborate, background for certain exemptions applicable to emission allowances, most of which are basically justified on the basis of the existence of sectoral legislation.[23] According to Article 6(3), in fact: "*This Regulation does not apply to the activity of a Member State, the*

[22] MAR, Recital (26): "*Use of inside information can consist of the acquisition or disposal of a financial instrument, or an auctioned product based on emission allowances, of the cancellation or amendment of an order, or the attempt to acquire or dispose of a financial instrument or to cancel or amend an order, by a person who knows, or ought to have known, that the information constitutes inside information. In this respect, the competent authorities should consider what a normal and reasonable person knows or should have known in the circumstances*".

[23] MAR, Recital (21) "*Pursuant to Directive 2003/87/EC of the European Parliament and of the Council, the Commission, Member States and other officially designated bodies are, inter alia, responsible for the technical issuance of emission allowances, their free allocation to eligible industry sectors and new entrants and more generally the development and implementation of the Union's climate policy framework which underpins the supply of emission allowances to compliance buyers of the Union's emissions trading scheme (EU ETS). In the exercise of those duties, those public bodies can, inter alia, have access to price-sensitive, non-public information and, pursuant to Directive 2003/87/EC, may need to perform certain market operations in relation to emission allowances. As a consequence of the classification of emission allowances as financial instruments as part of the review of Directive 2004/39/EC of the European Parliament and of the Council, those instruments will also fall within the scope of this Regulation. In order to preserve the ability of the Commission, Member States and other officially designated bodies to develop and implement the Union's climate policy, the activities of those public bodies, insofar as they are undertaken in the public interest and explicitly in pursuit of that policy and concerning emission allowances, should be exempt from the application of this Regulation. Such exemption should not have a negative impact on overall market transparency, as those public bodies have statutory obligations to operate in a way that ensures orderly, fair and non-discriminatory disclosure of, and access to, any new decisions, developments and data that have a price-sensitive nature. Furthermore, safeguards of fair and non-discriminatory disclosure of specific price-sensitive information held by public authorities exist under Directive 2003/87/EC and the implementing measures adopted pursuant thereto. At the same time, the exemption for public bodies acting in pursuit of the Union's climate policy should not extend to cases in which those public bodies engage in conduct or in transactions which are not in the pursuit of the Union's climate policy or when persons working for those bodies engage in conduct or in transactions on their own account*".

Commission or any other officially designated body, or of any person acting on their behalf, which concerns emission allowances and which is undertaken in pursuit of the Union's climate policy in accordance with Directive 2003/87/EC".

Clearly, therefore, there is a dual regulatory approach for emission allowances: on the one side, sectoral legislation, on the other, the standard, general market abuse regime, applicable to all financial instruments. However, considering the interplay between the two, after MAR, it is the latter that ultimately prevails, as clarified by recital (37)[24] and by Article 2(1), according to which: "*This Regulation also applies to behaviour or transactions, including bids, relating to the auctioning on an auction platform authorised as a regulated market of emission allowances or other auctioned products based thereon, including when auctioned products are not financial instruments, pursuant to Regulation (EU) No 1031/2010. Without prejudice to any specific provisions referring to bids submitted in the context of an auction, any requirements and prohibitions in this Regulation referring to orders to trade shall apply to such bids*".

In this respect, emission allowances are truly unique in the context of MAR, as this is a topic where Regulation 516/2014 actually "spills over" and directly regulates matters originally addressed by sectoral legislation. Naturally, this also has significant consequences in terms of enforcement, sanctions and related provisions.

The second peculiar dimension of emission allowances under MAR is the fact that the key notion of "inside information" for these products is much more linked to trades and position. Rules on disclosure and treatment of inside information are therefore addressed to market participants. The notion of "market participant" is not left to its potential ambiguity, but is clearly

[24] MAR, recital (37) "*Regulation (EU) No 1031/2010 provides for two parallel market abuse regimes applicable to the auctions of emission allowances. However, as a consequence of the classification of emission allowances as financial instruments, this Regulation should constitute a single rule book of market abuse measures applicable to the entirety of the primary and secondary markets in emission allowances. This Regulation should also apply to behaviour or transactions, including bids, relating to the auctioning on an auction platform authorised as a regulated market of emission allowances or other auctioned products based thereon, including when auctioned products are not financial instruments, pursuant to Regulation (EU) No 1031/2010*".

defined by Article 3(20): "'*emission allowance market participant' means any person who enters into transactions, including the placing of orders to trade, in emission allowances, auctioned products based thereon, or derivatives thereof and who does not benefit from an exemption pursuant to the second subparagraph of Article 17(2)*".[25]

The need to carve out emission allowances from the general approach of MAR in relation to inside information is clearly visible through the specific definition of "inside information" provided by Article 7, wherein emission allowances benefit from a specific definition, where no reference to an "issuer" (in the general sense of MAR) is made: "*(c) in relation to emission allowances or auctioned products based thereon, information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more such instruments, and which, if it were made public, would be likely to have a significant effect on the prices of such instruments or on the prices of related derivative financial instruments*".[26]

3.3.1. MAR: Inside Information Concerning Emission Allowances.

As with any other inside information, price sensitivity is naturally a pre-requisite for inside information concerning emission allowances as well, which needs to be assessed on the basis of the potential impact on market prices. Once again, emission allowances receive a particular treatment in MAR.

[25] Article 8(4) consequently establishes that "*This Article applies to any person who possesses inside information as a result of: (a) being a member of the administrative, management or supervisory bodies of the issuer or emission allowance market participant […]*".

[26] As a practical demonstration of the well-established attention to MAR precautions in relation to inside information, it is worth referring to the structure of the main allowances trading platforms, where regulatory reporting services are often provided with reference to MiFID II/MiFIR, REMIT Transaction Reporting, EMIR Trade Reporting and, above all, inside information reporting. See, for instance, the section "Regulatory Reporting Services" of the German auction platform (EEX DE) website, available at the following link: https://www.eex.com/en/markets/reporting-of-inside-information .

In this respect, recital (51) sets out that "*In order to avoid exposing the market to reporting that is not useful and to maintain cost- efficiency of the measure foreseen, it appears necessary to limit the regulatory impact of that requirement to only those EU ETS operators which, by virtue of their size and activity, can reasonably be expected to be able to have a significant effect on the price of emission allowances, of auctioned products based thereon, or of derivative financial instruments relating thereto and for bidding in the auctions pursuant to Regulation (EU) No 1031/2010*".[27] Setting a quantitative threshold of materiality for emission allowances is a specific exercise, which has no equivalent for other financial instruments falling within the scope of MAR. This peculiarity is, on the one side, the consequence of the lack of an "issuer" of financial instruments on the market , and, on the other side, the inter-relationship with other sectoral legislation. According to recital 52: "*Where emission allowance market participants already comply with equivalent inside information disclosure requirements, notably pursuant to Regulation (EU) No 1227/2011, the obligation to disclose inside information concerning emission allowances should not lead to the duplication of mandatory disclosures with substantially the same content. In the case of participants in the emission allowance market with aggregate emissions or rated thermal input at or below the threshold set, since the information about their physical operations is deemed to be non-material for the purposes of disclosure, it should also be deemed not to have a significant effect on the price of emission allowances, of auctioned products based thereon, or of the derivative financial instruments relating thereto. Such participants in the emission allowance market should nevertheless be covered by the prohibition of insider dealing in relation to any other information they have access to, and which is inside information*".

All of the above is clearly reflected in the disclosure regime applicable to market participants of emission allowances. According to Article 17: "*An emission allowance market participant shall publicly, effectively and in a timely manner disclose inside information concerning emission allowances which it holds in respect of*

[27] It is, again, noteworthy that this passage "links" the primary auction market, to secondary markets, by setting out that price sensitivity needs to be assessed on both sides: again, an approach that is peculiar to that of emission allowances.

its business, including aviation activities as specified in Annex I to Directive 2003/87/EC or installations within the meaning of Article 3(e) of that Directive which the participant concerned, or its parent undertaking or related undertaking, owns or controls or for the operational matters of which the participant, or its parent undertaking or related undertaking, is responsible, in whole or in part. With regard to installations, such disclosure shall include information relevant to the capacity and utilisation of installations, including planned or unplanned unavailability of such installations. The first subparagraph shall not apply to a participant in the emission allowance market where the installations or aviation activities that it owns, controls or is responsible for, in the preceding year have had emissions not exceeding a minimum threshold of carbon dioxide equivalent and, where they carry out combustion activities, have had a rated thermal input not exceeding a minimum threshold".

Also, rules applicable to the delay in disclosing inside information apply to: (a) emission allowance market participants in relation to inside information concerning emission allowances that arises in relation to the physical operations of that emission allowance market participant; and (b) any auction platform, auctioneer and auction monitor in relation to auctions of emission allowances or other auctioned products based thereon that are held pursuant to Regulation (EU) No 1031/2010.

Useful hints in order to identify what effectively amounts to inside information for emission allowances, particularly for the purpose of the disclosure regime under MAR, were provided, amongst EU Supervisors, by BaFin in Germany: "*The insertion <<in respect of its business>> in the first sentence of the first subparagraph of Article 17(2) clarifies that participants are only required to disclose inside information if they operate installations or aviation activities. Under certain circumstances, however, these may also include (legally independent) trading units if they belong to a company with activities within the meaning of the Emissions Trading Directive 2003/87/EC10 establishing a scheme for greenhouse gas emission allowance trading*". On the contrary: "*Other market participants such as credit institutions or brokers are not subject to the requirements of Article 17(2) of the MAR*".

As expected, differences between the regime applicable to emission allowances and other financial instruments tend to slim down when one considers the rules on market manipulation laid down in MAR, especially transaction-based manipulation, or even the prohibitions against insider trading. In this respect, in fact, emission allowances turn back to being (mostly) financial instruments like all others, save for the fact that — in line with the approach taken by MAR, and as a consequence of the repeal of the corresponding provisions of the Auctions Regulation — market manipulation prohibitions apply to emission allowances and also to *auctioned products* based on the allowances. Similar remarks apply to the indicators of manipulative behaviour set out in Annex I of the Regulation.

3.4. MiFID, MAR and REMIT.

Due to the interplay between capital markets legislation and sectoral EU legislation on emission allowances, similar concerns as those expressed in the context of MAR are to be found in the REMIT Regulation (Regulation n. 1227/2011 of October 25, 2011 on wholesale energy market integrity and transparency). There is clearly a link between wholesale markets on energy products and the MiFID-MAR regime, since abusive conducts on the first may have an impact on the secondary market of emission allowances. While recital 14 of REMIT provides examples of manipulative practices that are quite close to the ones that are captured by MAR, according to recital 13 of MAR: "*Manipulation on wholesale energy markets involves actions undertaken by persons that artificially cause prices to be at a level not justified by market forces of supply and demand, including actual availability of production, storage or transportation capacity, and demand.. (omissis)…Manipulation and its effects may occur across borders, between electricity and gas markets and across financial and commodity markets, including the emission allowances markets*".

The REMIT Regulation, albeit not directly applicable to emissions trading, is inspired, on this point, by principles similar to those that one finds in the typical field of securities markets regulation. As a matter of fact, contracts for emission allowances (as well as green certificates) are *not* wholesale energy products as they do not fulfil the requirements set out in Article 2(4) of REMIT.[28] However, these contracts can have a significant price effect on wholesale energy markets. According to Article 10 of REMIT, therefore, information on emission allowances or derivatives relating to emission allowances — collected by trade repositories or competent authorities overseeing trading in emission allowances or derivatives thereof — must be provided to the Agency for the Cooperation of Energy Regulators (ACER) together with access to records of transactions in such allowances and derivatives.

There are ultimately several interconnections between MAR and REMIT that were already developed in ESMA's Discussion Paper on MiFID II/MiFIR of 22 May 2014 (ESMA/2014/548). In particular:

i. MAR predominantly applies to financial instruments; however, it also expressly extends the scope of market manipulation and insider trading prohibitions to *spot commodity contracts* where any transaction or order in them or any behaviour in relation to them is likely to have an effect on the price or value of a financial instrument.

ii. Market manipulation and insider trading prohibitions set out in MAR do not apply to "wholesale energy products" as defined in Article 2(4) of REMIT. REMIT, in its turn, establishes a framework applicable to wholesale energy products encompassing spot and derivative contracts in electricity and gas. Therefore, while the REMIT obligation to publish inside information applies to both spot and derivative contracts in electricity and gas, the prohibitions of insider trading and market manipulation do not

[28] According to such article, "wholesale energy products" includes the following contracts and derivatives, irrespective of where and how they are traded: (a) contracts for the supply of electricity or natural gas where delivery is in the Union; (b) derivatives relating to electricity or natural gas produced, traded or delivered in the Union; (c) contracts relating to the transportation of electricity or natural gas in the Union; (d) derivatives relating to the transportation of electricity or natural gas in the Union. Contracts for the supply and distribution of electricity or natural gas for the use of final customers are not wholesale energy products. However, contracts for the supply and distribution of electricity or natural gas to final customers with a consumption capacity greater than the threshold set out in the second paragraph of point (5) shall be treated as wholesale energy products.

apply to financial instruments where MAR prevails, and financial regulators are the competent authorities.
In short, the interplay between REMIT and MAR-MiFID can be summarised by stating that wholesale energy products are exempted from the scope of MAR, except for the prohibitions of market manipulation and insider trading in electricity and gas derivatives, where REMIT declares MAR as applicable. It must be said, however, that the boundaries between these two areas of EU legislation are quite complex.

3.5. Exemptions Applicable to Emission Allowances Trading.

The choices made in the context of MiFID II in relation to the treatment of emission allowances naturally pose a tremendous issue in balancing the approach between financial markets legislation and control/regulation over the industrial sector. Ultimately, financial law is not intended to regulate industry directly.
The consequences arising from MiFID II are therefore assisted by a number of exceptions. Looking at derivatives in emission allowances, MiFID II maintains an approach similar to MiFID I, by exempting from its provisions trading in derivatives that is closely linked to the main line of a (broadly speaking) non-financial business, and is not provided in the context of other investment services: these are, also, exceptions that would apply to any kind of commodities derivatives, regardless of their underlying, and which are not specific to emissions trading.
Tailor-made exemptions, instead, do apply to emissions trading. The first is provided for by Article 1(1)(e) of MiFID II, and affects the trading of emission allowances that: (i) falls in the scope of the reporting requirements set out by the EU ETS Directive; and (ii) is carried out by dealing on own account, without providing services to clients. It should be noted, however, that this exemption *does not apply when algos or HFT techniques are employed*.
The second relevant case is the so-called ancillary exemption. According to Article 2(1)(j) of MiFID II, the Directive shall not apply to "*persons: (i) dealing on own account, including market makers,*

in commodity derivatives or emission allowances or derivatives thereof, excluding persons who deal on own account when executing client orders; or (ii) providing investment services, other than dealing on own account, in commodity derivatives or emission allowances or derivatives thereof to the customers or suppliers of their main business". However, the exemptions apply "*provided that: – for each of those cases individually and on an aggregate basis this is an ancillary activity to their main business, when considered on a group basis, and that main business is not the provision of investment services within the meaning of this Directive or banking activities under Directive 2013/36/EU, or acting as a market-maker in relation to commodity derivatives; – those persons do not apply a high-frequency algorithmic trading technique; and – those persons notify annually the relevant competent authority that they make use of this exemption and upon request report to the competent authority the basis on which they consider that their activity under points (i) and (ii) is ancillary to their main business*".

The presence of several exemptions based on the character of activities undertaken while dealing in EUAs also leads to different regimes. For instance, an entity that issues EUAs can be exempted from MiFID when it deals in EUAs on its own account, or provides services to customers on an ancillary basis. At the same time, exemptions might be partial in relation to transactions carried out for the purpose of hedging commercial risks of its parent parent company, and fully subject to MiFID for services provided to customers or suppliers if they exceed the thresholds for the ancillary exemption. Recital 22 of MiFID II seems to say that exemptions introduced by MiFID II apply cumulatively, and that combining exemptions should be allowed[29]: however, the simultaneous application on a single entity/person of the exemptions specified for in Articles 2 and 3 of MiFID II proved to be controversial[30].

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[29] See Financial Conduct Authority (FCA), *FCA Handbook. The Perimeter Guidance Manual. Guidance on the scope of the UK provisions which implemented MiFID and CRD IV.Q46A*, available at: https://www.handbook.fca.org.uk/handbook/PERG/13/?view=chapter.

[30] The Financial Conduct Authority – FCA, for instance, considered this as not allowed. *FCA Handbook…* Q46.

The specific criteria used to determine that an activity has an ancillary character in relation to the main business are set out in Articles 2–3 of the Commission Delegated Regulation (EU) 2017/592, and combine three tests: the Overall Market Threshold Test, Trading Test, and Capital Employment Test[31]. The ultimate result of this approach turned out to be, to say the least, a bit puzzling. Luckily, the Commission, in its proposal for the MiFID II 'Quick Fix' Directive, - presented on 24 July 2020 within the Capital Markets Recovery Package[32] - suggested to introduce some simplifications, as the quantitative elements of the ancillary tests were particularly complex, and ought be deleted[33]. Directive 2021/338 of 16 February 2021, and the Commission Delegated Regulation 2021/1833 of 14 July 2021 therefore introduced some most-welcomed modifications to the ancillary test.

A further attempt to balance MiFID II's far-reaching approach is also considered in the form of providing to Member States the possibility to adopt optional, additional exemptions. Under Article 3(1), "*Member States may choose not to apply this Directive to any persons for which they are the home Member State, provided that the activities of those persons are authorised and regulated at national level and those persons: provide investment services exclusively in emission allowances and/or derivatives thereof for the sole purpose of hedging the commercial risks of their clients, where those clients are exclusively operators as defined in point (f) of Article 3 of Directive 2003/87/EC, and provided that those clients jointly hold 100% of the capital or voting rights of those persons, exercise joint control and are exempt under point (j) of Article 2(1) of this Directive if they carry out those investment*

[31] See specifically Article 1–3 of Commission Delegated Regulation (EU) 2017/592 of 1 December 2016, OJ L 87 of 31.03.2017, pp. 492–499.

[32] Available at: https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1382.

[33] European Commission, COM(2020) 280 final, 2020/0152 (COD), Brussels, 24.7.2020, p. 10. See also, ESMA opinion on market size calculation (ESMA70-156-478), available at: https://www.esma.europa.eu/sites/default/files/library/esma70-156-478_opinion_on_market_size_calculation.pdf.

services themselves". This optional exemption, when introduced by EU Member States is, however, partial: Member States must, in fact, submit exempted persons to requirements that are at least analogous to the requirements under MiFID II (Article 3(2) MiFID II).

Ultimately, MiFID II sets out a landscape made of four different regimes for EUAs secondary markets: full application of the MiFID regime; full exemptions regulated by EU law; partial exemptions regulated by EU Law; national exemptions.

When trading emission allowances falls within the scope of MiFID II, the main consequences are those that typically derive from the application of investment services and activities regulations. The relevant entity would need to be licensed by a Competent Authority within the Union; fit and proper requirements apply to the management body and qualifying shareholders; prudential rules stemming from the IFR CRD IV would apply (and, among the latter, the quite sensitive topic of rules on remuneration). In most cases, this would result in a major industry player setting up an investment firm within the perimeter of its group. If MiFID II is applicable, the only other option available is that trading on emission allowances is carried out through a third-party bank or investment firm. In both cases, costs associated with trading in emission allowances are due to increase, either because these costs would directly be applicable to the regulated/supervised entity, or because services provided by third-party licensed firms would need to be remunerated.

3.6. The impact of MiFID II.

The consequences arising from the approach taken by MiFID II could be far-reaching, notwithstanding the fact that only time will tell how significant they will be. A first, preliminary and probably obvious remark is self-explanatory: trading in emission allowances now becomes an activity basically regulated by capital markets legislation, unless it falls into one of the various exceptions. This is not the first time, and it will not be the last, that new businesses, activities or services are included in that perimeter, even though the case of emission allowances seems to be, in many ways, a striking example of how far the perimeter may stretch. The approach taken in MiFID II, however, is clearly designed in such a way as to provide more transparency and efficiency to secondary markets on emission allowances. However, there is no reference, in the context of MIFID II, as to the impact that this may ultimately have on the protection of the environment and on the ultimate goal of the entire system of emission trading legislation, *i.e.* reducing the overall amount of CO_2 emissions. The approach taken in the context of MiFID II and MAR is, so-to-say, entirely within the perimeter of capital markets regulations. We believe, however, that the issue should be raised. Transaction costs in emission allowances trading are definitely increasing as a consequence of MiFID II, and it is unclear how these will be offset by the positive impacts of the new rules not simply within the scope of capital markets, but more widely on the environment. The trade off between these increased costs, and the expected enhancement in markets' liquidity, arising, for instance from compliance with MiFIR standards is still unclear. In the context of CO_2 emissions, capital markets legislation should not be considered as pursuing autonomous objectives: it should instead facilitate the ultimate goal of reducing emissions and improve the quality of the environment.

Sturdy statistical and analytical data will be needed in order to provide, in the next years, further clarification on this issue. Considering the difficulties that are usually encountered when measuring the concrete impact of emission allowances trading systems, it is likely that these data will not be available and conclusive for a long period of time. It will also not be easy to separate the effect of MiFID II from the impact that other measures, adopted locally and/or at an international level, will have on the reduction of emissions. from the more general measurements and evidences. There are, however, some pinpoints that can be set out and that should be considered.

Looking at the positive effects that may derive on environmental protection from the inclusion of emission allowances in the scope of capital markets legislation, these are basically linked to the fact

that—as a consequence of the approach stemming from MiFID II and MiFIR — secondary markets should effectively become more transparent, efficient and secure. In any case, empirical researches and evidences will be fundamental in order to assess and verify this correlation.
The increased transparency and efficiency of the market should lead more investors to consider emission allowances as a potential target for their asset allocation, thus increasing the depth of the market, and the significance of the prices of CO_2 allowances. Institutional investors — such as investment funds, pension funds, insurance undertakings — would also be in a position to consider emission allowances as suitable asset classes for their portfolio. The market for emission allowances will look more like a typical financial market, where different trading strategies would apply.
The reduced risk of market abuse practices in secondary markets for emission allowances should also increase transparency, and the efficiency of the price-discovery mechanism for emission allowances and relative derivatives. Since, as anticipated, all these are benefits that are also generally associated with traditional emissions trading programme, if MiFID II reaches its objectives it should reverberate positively on the reduction of CO_2 emissions, at least in the Union. Setting lower emission caps over time might become easier for legislators as the relative targets would be more easily attainable thanks to the increased efficiency of secondary market and trading activities on allowances.

4. Pros and cons.

The inclusion of EUAs into the full scope of MiFID resulted in a complex regulatory landscape. This is due to the combined operation of two forces: on the one side the structure of MiFID, and its quite complicated exemptions (partial or total); on the other side, the interplay between MiFID and other legislative measures that affect EUAs.
MiFID II regime also resulted in multiple trading venues being developed for EUAs, which now include regulated markets, multilateral trading facilities (MTFs) and organised trading

facilities (OTFs):, such as EEX (Germany), ICE Endex (Netherlands) and Nasdaq Oslo (Norway). This may support high levels of liquidity[34], but market fragmentation may ultimately have negative impacts on markets' efficiency[35].

Another element that needs to be considered is the increase in costs implied by MiFID II capturing EUAs. Trading professionally in emission allowances became more expensive after MiFID II, and transaction costs might impact negatively on the liquidity of the market. These costs, as literature suggests, are higher for smaller entitites[36].

The application of specific prudential requirements might also require the absorption of important level of capital that would be distracted from direct investments in the industry: the effect that this might have on the system is still, at the moment, unclear.

Considering the target of globally reducing greenhouse gas emissions, as already said, it is almost unanimously accepted that trading emissions does not directly contribute to such reduction. Environmental effectiveness of emission rights is in fact mostly the result of the reduction of EUAs available on the market.

However, the MiFID II regime might support a reduction of emissions below the cap if prices of EUAs rise and trading possibilities are reduced, as a consequence of the qualification of EUAs as financial instruments. In fact, if prices of EUAs rise significantly, this may lead to emitters adopting measures for reducing emissions directly, rather than resorting to secondary markets in order to buy extra allowances.

As shown by recent analysis, there has, indeed, recently been a significant increase in the price of EUAs. However, the increase in prices is probably due to factors that are not directly linked to

[34] See ESMA, *Final Report…*, p. 14.

[35] See, for China, K. Chang, R. Chen, J. Chevallier, "Market fragmentation, liquidity measures and improvement perspectives from China's emissions trading scheme pilots", Energy Economics 2018, Vol. 75, Issue C, p. 259.

[36] A.D. Ellerman et al., *Pricing Carbon: The European Union Emissions Trading Scheme,* Cambridge University Press, 2010, p. 259; R.H. Weber, *Emission Trading Schemes: A Coasean Answer to Climate Change?* in *Environmental Law and Economics* (eds. K. Mathis, B.R. Huber), New York: Springer International Publishing, 2017, p. 369.

MiFID. In fact, an increase in price has been associated with the introduction, in 2018, of the Market Stability Reserve (MSR)[37], and, more recently, with geo-political factors, including the pandemic[38], and, lately, the war in Ukraine[39]. In any case, the price of EU allowances (EUAs) has suffered major variations since its inception: in 2006, there was a fall in the demand, due to the fact that regulated installations had been overallocated; (ii) in 2008, the Financial Crisis had its effect on the EU ETS, resulting in a shrunken demand on the carbnon market; (iii) at the beginning of Phase III (2013), the EU ETS showed a surplus of about two billion allowances, greater than the volume of annual emissions. As a consequence, prices in EUA dropped. The decions, taken in 2012, by the Commission to postpone the auctioning of 900 million allowances from 2014-2015 to 2019-2020 (the so-called backload), was only partially successful and in 2015, the MSR was established:

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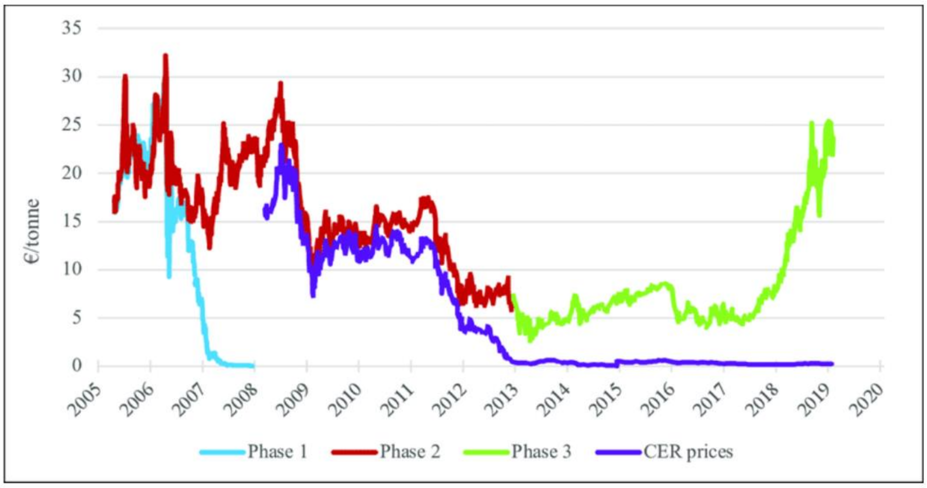
[37] See G. Perino, M. Willner, "EU-ETS Phase IV: allowance prices, design choices and the market stability reserve", Climate Policy 2017, Vol. 17, No. 7, p. 937, who argue that the introduction of the MSR is expected to increase prices of EUAs in the short term, but that, in the long term, the effect on prices will be irrelevant. See also Ch. Flachsland, M. Pahle, D. Burtraw, O. Edenhofer, M. Elkerbout, C. Fischer, O. Tietjen and L. Zetterberg, "How to avoid history repeating itself: the case for an EU Emissions Trading System (EU ETS) price floor revisited", Climate Policy 2020, Vol. 20, No. 1, p. 134–135 very long run, the price path remains unaffected.

[38] Oxera Consulting LLP, "Carbon trading in the European Union. An economic assessment of market functioning in 2021", 15 February 2022, 44–46, available at: https://www.oxera.com/wp-content/uploads/2022/02/Oxera-EU-carbon-trading-report-2.pdf.

[39] See ESMA, *Final report…*, p. 7: "*ESMA is acutely aware that the war in the Ukraine has a major impact apparently also on the carbon market. While EUA prices were declining by 30% in just a few days in late February and early March, natural gas prices reached all-time highs in Europe. There are a number of macro-economic and also technical factors which may explain these latest developments specifically in the carbon market which ESMA is referring to in this report. There are indications that the decline in the carbon price may be associated with concerns around possible gas supply disruptions or import bans leading to a reduced need for emission allowances, combined with general assumptions concerning an economic downswing and EU countries exiting fossil fuels at an earlier point in time but additional analysis may be required in the future*".

backloaded allowances were stacked as its initial reserve[40]. Prices have risen considerably after that.



EUA and CER prices, 2005-2019

Fig. 1: Source, European University Institute.
https://fsr.eui.eu/eu-emission-trading-system-eu-ets/

In its recent report, ESMA noted that the increase in EUA prices seems to be the result of an increased trading activity by emitters (either diretly or thorugh intermediaries), and not by speculative traders[41]: the percentage of trades that might be considered as speculative trade remains remains low [42].
Therefore, at least until now, there does not seem to be a relationship between MiFID II, surges in speculative trading on EUAs, and the increase in prices. This conclusion confirms the impression that there is no strong evidence on the fact that the inclusion of EUAs in the scope of MiFID may effectively impact on the reduction of emissions.

[40] The MSR is a mechanism that adjusts the number of allowances to be auctioned to the market surplus (*i.e.*, the difference between the cumulative amount of allowances available for compliance at the end of a given year, and the cumulative amount of allowances effectively used for compliance with the emissions up to that given year).

[41] ESMA, Final report… p. 44 ss.

[42] ESMA, *Preliminary report…*, p. 35.

5. Conclusions.

The foregoing considerations lead us to the general conclusion that the reform of the secondary trade in EUAs advanced by MiFID II exerts antagonistic effects on the economic effectiveness of the EU ETS. On the one hand, the costs of participation in the secondary trade in EUAs have increased for all categories of market participants, including emitters of greenhouse gases that trade in EUAs for the purposes of compliance with the EU ETS. Under MiFID II, the costs associated with trading in EUAs has generally increased due to compliance requirements From this perspective, the economic effectiveness of the EU ETS has been negatively affected. On the other hand, it appears that neither massive fragmentation of the legal regime for the secondary trade in EUAs, nor increased costs of that trade,,outweigh benefits brought to traders by increased legal security provided for by MiFID II. In fact, an increase in prices of EUAs, and, consequently, in energy prices, is generated predominantly by factors other than the reform of the secondary trade in EUAs advanced by MiFID II. The secondary market in EUAs constantly grows, and this growth can be explained as the MiFID II effect. In light of the available data, recognition of EUAs as financial instruments generated a strong incentive for greenhouse gas emitters and financial intermediaries acting on their behalf to participate in trade in EUAs. The risk of an increase in speculative trading has not yet materialised.
Ultimately, all of this must, sooner or later, come to grips with an excessively complex and fragmented legislative environment.
There are at least two, if not three, different sets of comprehensive EU legislation that may potentially be relevant for trading emission allowances, either on the spot, or on the derivatives market: the "old" EU ETS; MiFID II-MAR; and, more tangentially, REMIT. Opting in and out of each of these systems, through a complicated structure of exemptions and exclusions, does not benefit the overall coherence of the regulatory approach. As always, when rules are too complicated, there is a risk of negative externalities, and of reducing the positive outcomes that might be

expected from legislation. Keeping an eye to proportionality and to striking a proper balance between finance and industry may, ultimately, prove useful, as long as regulation remains flexible and clear enough.